IN THE

Supreme Court of the United States

OCTOBER TERM, 1943.

No.———

NATIONAL SECURITIES CORPORATION,

SUCCESSOR BY MERGER TO

AMERICAN GAS & ELECTRIC SECURITIES CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

I.

OPINION BELOW.

The opinion of the Circuit Court of Appeals is not yet officially reported, but appears in the record at pages 66 to 72, incl.

II.

JURISDICTION.

The jurisdiction of this Court is invoked under the provisions of the Judicial Code, Section 240, as amended by Act of Congress, February 13, 1925, 43 Stat. 938 (U. S. C. A., Tit. 28, Sec. 347).

III.

STATEMENT OF THE CASE.

A full statement of the case has been given under the heading "A" in the petition for certiorari (pp. 2-6, *supra*), and in the interest of brevity is not repeated here.

IV.

SPECIFICATION OF ERROR TO BE URGED.

1. The Court of Appeals erred in holding that section 45 of the Revenue Act of 1936 authorizes the Commissioner of Internal Revenue to disallow as a deduction a loss computed in accordance with the specific provisions of sections 23, 112 and 113 of the same Act, merely because the Commissioner, exercising the discretion granted him by the terms of section 45, determines that such action is "necessary in order clearly to reflect the income."

V.

STATUTES INVOLVED.

The statutes involved are set forth in the appendix *infra*, pp. 18-20.

VI.

ARGUMENT.

The Court Below Has Decided an Important Question of Federal Law Which Has Not Been, but Should Be, Settled by this Court.

Section 23(f) (Appendix, p. 18) provides that there "shall be allowed" as a deduction to a corporation "losses sustained during the taxable year."

Section 23(h) (Appendix, p. 18) provides that the basis for determining the *amount* of deduction for losses sustained, "to be allowed under subsection (e) * * * shall be the adjusted basis under section 113(b)."

Section 113(b) (Appendix, p. 19) provides that the "adjusted basis for determining the gain or loss from the sale or other disposition of property * * * shall be the basis determined under subsection (a)", with adjustments not here applicable.

Section 113(a)(8) (Appendix, p. 19) provides that the basis of property acquired by issuance of stock in connection with a transaction described in section 112(b)(5) shall be the same as it would be in the hands of the transferor.

Section 112(b)(5) (Appendix, p. 19), which is entitled "Transfer to Corporation controlled by Transferor", provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock in the corporation, if the transferor is thereupon in control of the corporation.

All of this language is in terms mandatory and, as applied to the facts of the instant case, clearly means that the taxpayer, American Gas & Electric Securities Corporation, "shall be" allowed a loss on the sale by it of the Standard stock measured by the excess of the cost of that stock to the parent corporation over the amount received by the taxpayer on the sale thereof. There is no other provision of the revenue law dealing specifically with such a transfer of property to a controlled corporation, the subsequent sale of the property, and allocation of gain or loss thereon. The Board of Tax Appeals and the Circuit Court of Appeals, however, held that section 45 empowers the Commissioner to deny this right of deduction in the instant case; in short that section 45 authorizes the Commissioner, if and only if he, in his discretion, deems it appropriate to do so, to adopt some other method of measuring the loss than that which Congress has so carefully spelled out. No other case on record has ever gone so far. Since Section 45 of the 1936 Act has been re-enacted without change in all subsequent revenue laws, it is a matter of great importance to determine whether the construction so placed upon the law is so obviously correct as to justify this Court in refusing to review it.

Section 45 (Appendix, p. 20) purports to authorize the Commissioner to allocate income or deductions in the case of corporations owned by the same interests (as were the parent and the taxpayer here), if he determines that such allocation is necessary in order (a) "to prevent evasion of taxes", or (b) "clearly to reflect the income" of the two corporations. Since the record is clear (see pp. 3-5, *supra*) that this case involved no question of possible tax evasion,[1] and since the Commissioner (R. 71) based his action on a claim that "allocation was necessary in order clearly to reflect income", the question comes down to this:

Where Congress has provided a definite method of allocating the gain or loss on sale, by a controlled corporation, of property acquired, in exchange for stock, from its controlling stockholder, may the Commissioner of Internal Revenue, under the general provisions of Section 45, prescribe a different method of computation and allowance, simply because he believes the statutory method does not produce a result which "clearly reflects" income?

Any one of several methods could, with equal plausibility, have been prescribed by Congress for measuring the tax result of such a transaction here:

(1) Since the general rule is that *cost* shall be the basis for computing gain or loss on sale, Congress could have provided that the taxpayer's basis should be the value of the consideration given by the taxpayer (namely, its own stock) in exchange for the Standard stock. In fact, this is the general rule applied to the acquisition of property for

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[1] The Board of Tax Appeals failed to make any findings of fact concerning the motives which dictated the transfer of the Standard stock, and in its opinion (R. 21) treated such motives as immaterial. The Circuit Court of Appeals affirmed on the "clear reflection of income" theory (R. 71). In any event, the stipulated facts and undisputed testimony, which are summarized at pp. 3-5, *supra*, make it clear that the tax effects could not have been foreseen and were not taken into consideration at the time of that transfer.

stock (in the absence of "control" of the transferee by the transferor).[2]

(2) Since the transfer from controlling stockholder to controlled corporation effected no substantive change in economic ownership, it could reasonably be provided (as Congress did provide in sections 112(b)(5) and 113 (a)(8), Appendix, pp. 18-19, *infra*) that the recognition of taxable gain or deductible loss should be postponed until sale to outside interests, and that the result, measured by original cost to the transferor, should then be reflected in the accounts of the selling corporation.

(3) Congress could have provided a rule that gain or loss on transfer from controlling stockholder to controlled corporation should be measured, for tax purposes by the difference between cost to transferor and value at the time of transfer, and that the transferee should take this value as its basis for computation on subsequent sale to outside interests. This is the method adopted by the Commissioner in the instant case, and his action was approved by the Court below on the theory that the parent sustained the loss when it transferred the Standard stock to the taxpayer. (R. 71)

Congress adopted the second of these three alternatives. In section 202(c)(3) of the 1921 Act[3], it provided that no gain or loss should be recognized on the inter-company exchange, and in section 204(a)(8) of the 1924 Act[3], it provided that the basis for determining gain or loss on sale by the transferee should be the same as would have been the transferor's basis. In explanation of the latter section, the Senate Finance Committee stated[4] that the theory was the

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[2] *Hyatt Roller Bearing Co.* v. *United States*, 43 F. (2d) 1008; *Amerex Holding Co.* v. *Commissioner*, 37 B. T. A. 1169, 1188, aff'd. 117 F. (2d) 1009.

[3] Re-enacted in substance in all subsequent Acts.

[4] Senate Committee Print, 68th Cong., 1st Sess., dated March 6, 1924, "Statement of the Changes made in the Revenue Act of 1921 by H. R. 6715 and the Reasons Therefor", p. 13.

same as that underlying the similar provision as to basis for property acquired in connection with a reorganization, namely, that the provisions of the section "represent the logical counterpart" of the provisions of section 203 which exempted the exchange from taxation.

The Commissioner in the instant case, therefore, has condemned as not clearly reflecting the income a method of computation and deduction which Congress adopted as "logical" by incorporating it in the statute. The Court of Appeals approved this action on the ground that "the Commissioner's action was neither arbitrary nor capricious", and that it is "most reasonable to treat the loss as one which had in fact been sustained by the parent rather than by its subsidiary." (R. 71)

Since there are at least three "reasonable" methods of taxing such a transaction, as above pointed out, the adoption of no one of them would involve "arbitrary or capricious" conduct on the Commissioner's part, if he were clearly given the power to determine the question. If the test adopted by the Board and the Court of Appeals be sound, therefore, the Commissioner in every similar case is at liberty to choose any one of at least three methods of computation, each with different tax consequences, but is not *required* to deviate from the method prescribed by section 113(a)(8). In the instant case, if he had adopted the first alternative above mentioned, the loss would have been $66,425.00[5]; the adoption of the second method would have sustained the loss of $133,203.06 claimed by the taxpayer; and use of the third would have resulted in a loss of $1,387.50. Yet none of these widely varying results could have been disturbed by the courts, if the decision below be correct, because none would involve "arbitrary or capricious" conduct.

Is it reasonable to assume that Congress, in enacting section 45, intended to give the Commissioner this wide lati-

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[5] *i. e.*, value of taxpayer's stock exchanged for the Standard stock, $73,600 (R. 15), less the sale price of $7,175.00.

tude in determining the method of computing gains and losses? The mere statement of this question, we submit, demonstrates the desirability of a definitive answer by this court.

If, on the other hand the Court of Appeals means to say that there can be only one "reasonable" way of clearly reflecting the income, that being the method approved in this case, it becomes necessary to conclude that the method prescribed by Sections 112 and 113 should never be used; that the Commissioner must always treat such an exchange of property for stock as resulting in a loss to the parent, despite the injunction of Section 112 that such loss shall not be recognized; and that he must always allocate to the parent that part of the loss represented by the depreciation in value at the date of exchange, despite the precise requirements of Section 113 that the entire loss be allocated to the subsidiary.

The Court below justified its conclusion (R. 70) by saying:

> "In every case in which the section is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act. If this were not so Section 45 would be wholly superfluous."

The answer to this, we submit, is that, while Section 45 deals *generally* with the allocation of income and deductions in the case of businesses "owned or controlled * * * by the same interests" sections 23, 112, and 113 deal *specifically* with the precise type of transaction here presented, namely, a transfer of property by one of such "controlled" businesses to the other, and the subsequent sale of the property by the latter. In short, section 113 (read, as it must be, in connection with section 23) is like section 45 to the extent that it lays down a rule for allocating between stockholder and corporation the loss resulting from the sale by a controlled corporation of property acquired from a controlling

stockholder. The only substantial difference between section 113 and section 45 is this: Section 113 deals specifically with one type, and only one type, of transaction, while section 45 is general in terms, dealing with the allocation of all types of income and deduction. It is an elementary rule of statutory construction that, where a general provision, in its most comprehensive sense, might include what is embraced in a particular enactment, the particular statute must be operative, and the general enactment must be limited to those cases within its general language which are not within the provisions of the particular enactment. *United States* v. *Chase*, 135 U. S. 260, 34 L. ed. 117, 119.

While Section 45 may empower the Commissioner to allocate other types of deduction for which Congress has provided no specific rule, he must, in a field where Congress has laid down such a rule to govern transactions with a "controlled" corporation, follow that rule. Otherwise, the specific rule so prescribed would have no force or effect, except at the Commissioner's whim. If Section 45 permits the Commissioner to prescribe some other method of computation because the application of Section 113(a)(8) does not clearly reflect the income, then it would be his duty to ignore that section in *all* cases of this type, except those rare cases where there is no change in value of the property between the date of its purchase by the stockholder and the date of its sale by the "controlled" corporation, in which cases the same result would flow from following either method.

Under the decision below, therefore, so long as Section 45 exists there will never be a case which Section 113(a)(8) could govern, and the reasoning of the Court of Appeals would lead to the conclusion that Section 113(a)(8) is "wholly superfluous."

An interpretation which produces such absurd consequences, we submit, should be reviewed by this Court.

CONCLUSION.

For the foregoing reasons, we respectfully submit that this petition for a writ of certiorari should be granted.

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